

discretion, price flexibility will predictably result in reductions designed primarily to deter competition."<sup>115</sup>

**2. Volume and Term Discounts.** The comments also support AT&T's position that additional volume and term discounts<sup>116</sup> should not be allowed until actual competition develops.<sup>117</sup> As MCI points out, term and volume discounts "explicitly allow selective price reductions to forestall competition, rather than to foster it [and] do not confer any benefit to customers in other markets and circumstances."<sup>118</sup>

The Commission has identified certain limited circumstances where such discounts are cost justified. In all other cases the discounts will not be cost justified,<sup>119</sup> and thus allowing the ILEC to offer such discounts will permit the ILEC to cross-subsidize from non-competitive areas.<sup>120</sup> Term discounts also allow an ILEC to lock in long-term customers at its current rates.<sup>121</sup> These long-term contracts will prevent those customers from realizing the benefits -- in the form of lower prices -- of future competition and, by removing desirable large-volume customers from the market,

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<sup>115</sup>See Kwoka at 20 (MCI).

<sup>116</sup>AT&T also supports the Commission's conclusion, NPRM ¶192, that it is not in the public interest to allow the ILECs to provide growth discounts. The Commission is correct that these discounts are not cost-justified and would allow ILECs to circumvent the nondiscrimination provisions of Section 272. Id.; see Kwoka at 20-21 (MCI).

<sup>117</sup>If the Commission does decide to allow additional term and volume discounts, "[a]t a minimum, the Commission should require incumbent local exchange carriers rigorously to cost-justify any [volume or term discount] proposal -- in addition to making the competitive check-list showing." Frontier at 15.

<sup>118</sup>Kwoka at 20 (MCI).

<sup>119</sup>See MCI at 58 ("there is no evidence that there is a cost basis for volume discounts for access services other than transport. . . . Volume discounts would simply be a mechanism for the incumbent LEC to discriminate between different classes of access customers."); see also ACTA at 18 ("Volume discounts, by their very nature, are discriminatory.").

<sup>120</sup>See Tele-Communications, Inc. at 28.

<sup>121</sup>See Comp. Policy Inst. at 28; MCI at 58; CompTel at 23. The comments of ACC Long Distance (at 8 n.14) provide an example where NYNEX used a term discount to undermine its entry in upstate New York.

will also deter new competitors from entry.<sup>122</sup> Furthermore, the ILECs "could come up with a deeply discounted, very long-term discount that would appeal only to" the ILEC-affiliated IXC. Sprint at 44. Even if these discounts were offered to other carriers, the ILEC could tailor these offerings to the needs of its own affiliates, and competing carriers may be wary of entering long-term agreements in a dynamic emerging competitive environment.

USTA's assertion that consumers are better off if the ILECs can prevent customer loss to CLECs through the use of volume and term discounts because joint and common costs are borne more evenly (Schmalensee and Taylor at 30-31 (USTA)) is also flawed in a number of respects. First and foremost, the long-run prices that would emerge in a competitive market would allow for recovery of these costs because they are costs an efficient entrant would incur. Baumol/Ordover/Willig (Appendix A). Second, volume and term discounts allow incumbents to deter entry by lowering costs below competitive levels through cross-subsidies from noncompetitive markets. This threat may discourage firms which are even more efficient from entering. And it will certainly discourage equally efficient competitors.

**3. Contract Tariffs.** There is a similarly widespread consensus among the commenters that the ILECs should not be able to offer contract tariffs. These tariffs, which usually contain both volume and growth discounts, would allow ILECs to engage in predatory pricing and erect barriers to entry and to discriminate in favor of their affiliated IXC carrier. See, e.g., ACTA at 18-19.

As MCI points out (at 61-62), the availability of contract tariffs would enable the ILECs, because of their significant market power, to price discriminate in favor of their affiliated IXC carriers, even if the ILECs faced substantial competition. Although the Commission has established a goal of explicitly associating switched access charges with costs, "there is a serious risk that contract tariffs and RFPs may not be cost based, since the Commission's requirements of cost

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<sup>122</sup>ACC Long Distance at 7-8 (allowing incumbents to provide volume and term discounts on access will enable them to target medium and large businesses, which are traditionally the first customers a competitive provider targets).

justification under ICBs may provide no meaningful opportunity to ensure that rates are fair, non-discriminatory, and not predatory in effect." TCG at 45.

As Sprint points out (at 45), the fundamental problem with contract tariffs is this: If an ILEC has the ability to provide contract tariffs, it will be able to tailor that tariff, in a discriminatory manner, to meet the particular needs of the ILEC-affiliated IXC. "The requirement that a tariff be 'generally available to similarly situated customers under substantially similar circumstances' is insufficient. It ignores the fact that tariffs are easily constructed so that only one user is positioned to adopt them, even if ostensibly offered to all." MCI at 61-62.<sup>123</sup>

The Commission should prohibit ILECs from providing these tariffs until there is substantial competition.<sup>124</sup> The Commission's "startling" proposal to allow such tariffs in the absence of competition will severely inhibit the ability of CLECs to compete effectively with the ILECs. Time Warner at 33. If the Commission is attempting to address "the pressure placed on rates by network prices, the proper remedy is cost-based rate restructuring and rebalancing, not the freedom to selectively drop rates for targeted customers." *Id.* at 31-32.

**4. New Services.** The commenters also agree that the Commission should not deregulate new services at this time. Deregulation of new services would allow ILECs to discriminate in favor of their affiliates -- the ILECs would be able to repackage existing services into a "new" service and then offer it at a discount on restrictive terms such that the new service

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<sup>123</sup>U S WEST nevertheless maintains that the ILECs should be permitted to offer contract tariffs because AT&T was given this flexibility in the IXC market before the Commission found AT&T to be a non-dominant carrier. In fact, AT&T had authority to use contract tariffs only for services for which the Commission found that there was substantial competition. See In re Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, 6 FCC Rcd. 5880, 5894 (1991) (Commission found business services market to be competitive and thus allowed AT&T to file business service contract tariffs); see also In re Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, 8 FCC Rcd. 3668, 3671-72 (1993).

<sup>124</sup>"[A] significantly greater level of competitive entry is necessary to prevent the use of contract tariffs strictly for entry deterring and predatory purposes. Contract carriage provides the incumbent LEC with unfettered pricing flexibility, giving it the opportunity to disrupt competition in the access market." MCI at 60; see also Kwoka at 21 (MCI) ("Protections such as the requirement that there be "constraining competition" should be imposed to prevent the use of contract tariffs strictly for entry deterring or predatory purposes.").

would be available only to the affiliate. Additionally, the deregulation of new services "would allow an ILEC to label unbundled pieces of pre-existing services as 'new.' The ILEC could then quickly establish uneconomic rates for the unbundled pieces of various 'old' services upon which new entrants must rely to provide service. This would drive up the new entrants' costs and harm competition." <sup>125</sup>

**5. High Cap and Special Access.** The commenters also uniformly reject ILEC arguments that special access services are competitive and therefore eligible for forbearance.<sup>126</sup> The CAP providers simply do not present the type of substantial competition to ILECs that the Act envisions and requires; instead, CAPs "provide only high capacity services to a limited number of customers in a limited number of buildings in the largest cities." MCI at 64. Thus, any "competitive" market created by the presence of CAPs exists in isolated pockets,<sup>127</sup> and is unable to produce widespread benefits to consumers in any significant geographic area.<sup>128</sup> If the Commission elected to remove special access services from price caps and tariff regulation, this would clearly

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<sup>125</sup>Time Warner at 33-34. As MCI has noted (at 62-63), "the price capped firm can offer a scarcely different 'new' service outside the cap at a price that attracts most customers from the original capped service. This results in a very low demand weight on the latter, so that its price may thereafter be increased without much adverse effect on other capped prices. That, in turn, allows the price of the unregulated service outside the cap to increase to near-monopoly levels."

<sup>126</sup>With regard to special access services, the NPRM "lacks any information or conclusions regarding the degree of competition that exists, including quantification." API at 37; see also California at 10 ("The concept of eliminating price regulation of high-capacity special access services is based on the unsubstantiated contentions of ILECs that there is already of [sic] "intense competition" for these services").

<sup>127</sup>SpectraNet at 5 ("Although competition is clearly increasing for high-capacity access, it is patchwork and sporadic at best."); cf. California at 10 ("California has experienced significant competition for transport services in recent years, but only in particular geographic areas.").

<sup>128</sup>As MCI points out (at 68), "Even in areas where a CAP is present, businesses that are not located in buildings served by the CAP cannot easily substitute the CAP's services for the LEC's services. As a result, the LEC could exercise significant market power over customers not on the CAP's network." Further, as the Pennsylvania Internet Service Providers note (at 17), "it is not enough to have just one or two alternative providers in an area. As we have seen repeatedly in other areas, replacing a monopoly with an oligopoly does not guarantee that the market will work competitively. Indeed, it is very likely that . . . consumers will lose the protection of regulation without receiving the benefits of competition. This is the worst of both worlds and must be avoided."

enable "the incumbent LEC to discriminate unreasonably between users" (MCI at 68) and, worse, to erect barriers to entry such as the kind of price squeeze discussed above.

6. **Directory Assistance.** The argument by several ILECs that the provision of Directory Assistance is already competitive, and thus eligible for immediate forbearance, is also misguided. Contrary to arguments by SNET and CBT, for example, the availability of directory information from sources such as the Internet and CD ROMs does not render these services competitive. For example, the availability of printed directories from a non-ILEC publisher does not provide competition for an ILEC's operator-provided directory assistance. Such printed directories provide a different service, which may marginally impact consumption of the ILEC's directory assistance service, but in no way provides substantial competition for that service. Accordingly, the cited alternate sources for the information provided by directory assistance is insufficient to support the ILECs' claim that these services are eligible for forbearance.

7. **Differential Pricing.** The Commission should also decline to allow ILECs to engage in differential pricing across customer classes. It is likely that competition will develop in certain customer classes before others. Through the use of differential pricing, an ILEC would be able to use a noncompetitive class to cross-subsidize a competitive one. As the Texas PUC points out (at 20), such cross-subsidization would disproportionately harm residential customers -- as that class of customers is not likely to become competitive until after business classes do -- and would impede the development of competition.

In sum, for all these reasons, the ILECs should not be given additional pricing flexibility until they can demonstrate the *existence* of genuine competition, regardless of which overall approach the Commission adopts to reforming access charges.

**D. The Wide Variety Of Approaches Endorsed By The Commenters Clearly Illustrates The Need For The Commission To Conduct A Separate Rulemaking On The Appropriate Prerequisites For Additional Pricing Flexibility.**

In all events, the sheer complexity of the debate between ILECs and their customers on the propriety of additional pricing flexibility confirms and illustrates the need for the Commission to conduct a separate rulemaking on the appropriate prerequisites for relaxing price cap regulation. The commenters agree that it is premature to establish the criteria for evaluating the competition

faced by incumbent LECs, because no one can predict how the access market will evolve, or even if competition will ultimately be successful.

To the extent, however, that the Commission wishes to adopt any metrics in this proceeding, any such scheme must require significant facilities-based competition. The commenters agree that "anything short of meaningful facilities-based competition is ephemeral." TRA at 17; see also Ohio Consumers' Counsel at 2; API at 18; Time Warner at 27.

Moreover, the Commission should not fall into the trap set by the ILECs that advocate criteria that would "presumptively" find competition where none exists at all. For example, Ameritech (at 29) urges the Commission to hold that "demand-elasticities are presumptively high" because all that buyers require is a functionally equivalent alternative and they will readily switch due to small price changes. Demand responsiveness at inflated prices, however, is not the relevant inquiry because even a profit maximizing monopolist sets prices where demand is elastic. Baumol/Ordover/Willig (Appendix A). What is relevant is demand responsiveness at competitive and near competitive prices. These are the prices that an efficient firm might offer and to which incumbent LECs would respond.

In all events, demand responsiveness will likely be so low that widespread entry will remain futile in most markets for many years. First, anticompetitive practices -- including price and non-price behavior -- by the ILEC may improperly render competitive alternatives inferior. Absent a substantial alternative facilities-based provider, a CLEC will still be dependent on the ILEC in providing service to the customer, a condition the ILEC remains capable of exploiting to its advantage. Second, the presence of term contracts, which would be more prevalent under the expanded regulatory flexibility proposed at Phase 1, seriously hampers demand responsiveness. Finally, the availability of an alternative supplier for a single building in a major metropolitan area certainly does not justify the conclusion that other businesses or residential consumers also have similar price sensitivities. Their perceptions about quality as well as name brand loyalty may make them less price responsive. For all these reasons, it would be more reasonable to presume low demand responsiveness until the ILEC has clearly demonstrated otherwise.

Similarly, supply elasticity must not be treated in a cavalier fashion. The existence of an interconnection agreement or statement of generally available terms does not address the various barriers to entry discussed above. Furthermore, under USTA's time table, entry might not occur for up to two years, and even then fail to constrain prices. Supply responsiveness must actually exist, not simply be wished into existence.

In this regard, it is telling that the ILECs discourage the Commission from considering pricing trends and market share in assessing the level of competition. Their market shares far exceed that possessed by AT&T when the Commission chose to continue substantial price cap regulation. Moreover, if the ILECs are correct in their assessment of probable competitive effects, then pricing trends should follow a downward path. Indeed, that is the basis for their claim that market forces are sufficient to produce efficient prices. Their attempts to deflect the Commission from examining pricing trends strongly suggests that market forces will not adequately constrain incumbent behavior.

### CONCLUSION

For these reasons, the Commission should adopt a policy of reinitializing price caps rather than a "market-based" approach to access charge reform, decline to give the ILECs additional pricing flexibility until genuine competition has been demonstrated, and adopt the other measures described above.

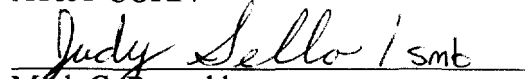
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February 14, 1997

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**AFFIDAVIT OF WILLIAM J. BAUMOL,  
JANUSZ A. ORDOVER, AND ROBERT D. WILLIG**

1. Our names are William J. Baumol, Janusz A. Ordover, and Robert D. Willig. William J. Baumol is Director of the C.V. Starr Center for Applied Economics at New York University and Professor Emeritus at Princeton University. Janusz A. Ordover is Professor of Economics at New York University. Robert D. Willig is Professor of Economics and Public Affairs at Princeton University.

2. We submit this affidavit in response to the Federal Communication Commission's (the "Commission") December 24, 1996 Notice of Proposed Rulemaking in CC Docket No. 96-262, *Access Charge Reform* (the "NPRM"). We also filed an affidavit during the initial round of comments in which we discussed the flaws in the Commission's "market-based" approach and the need immediately to reduce exchange access rates to TSLRIC/TELRIC levels, for the sake of competition and consumers. In particular, the "market-based" approach -- which could more aptly be titled the "monopoly-pricing" approach" — would exacerbate the existing distortions in the provision of access, increase access rates, distort competition in the long distance market, and provide additional sharp incentives for ILECs to stymie UNE-based local and bundled competition. A "flash-cut" to access rates based on forward-looking, long-run economic costs, on the other hand, would be procompetitive and provide consumers with billions of dollars in savings immediately. Accordingly, we urged the Commission to require that long-distance access rates be set on the basis of TELRICs as soon as is possible and to defer deregulation until effective competition arrives.

3. In this affidavit, we discuss some of the economic issues that have played a prominent role in the first round of comments. We organize our responses around three principal propositions. First, it is critical to recognize that an interconnection agreement does not ensure the effective local competition that is necessary to warrant access deregulation. Second, the FCC's proposed "market-based" approach to access pricing substantially magnifies ILEC incentives for engaging in practices that anticompetitively disadvantage rivals. Third, we emphasize that the Commission must adopt rational standards for assessing the effectiveness of market forces in constraining ILEC pricing behavior.

**I. An Interconnection Agreement Does Not Ensure The Effective Local Competition That Is Necessary To Warrant Access Deregulation**

4. The Telecommunications Act and the FCC have made significant strides towards opening local exchange markets to competition. Under the Act and the *Local Competition Order*, the primary vehicle for competitive entry is a negotiated or arbitrated interconnection agreement between the incumbent carrier and one or more competitive carriers.<sup>1</sup> Most importantly, these agreements provide terms for resale, the purchase of unbundled network elements, and the mutual exchange of traffic.

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<sup>1</sup> A Statement of Generally Available Terms ("SGAT") would be another -- though potentially inferior -- umbrella for competitive entry. The observations contained in our affidavit apply equally to interconnection agreements and SGATs.

5. Contrary to the position of the ILECs, the existence of such an agreement does not indicate that legal and economic barriers to entry have been eliminated. While the existence of an interconnection agreement is a necessary precursor to competition, alone it will rarely suffice to enable or create the effective competition that is necessary for deregulation of access to be warranted for the public interest.

6. Many of the commentators stake their recommendations for transition towards deregulation of access on the view that the Act opened local telecommunications markets to competition. In particular, these commentators argue that UNE-based competition will offer an effective constraint on the ILECS' ability to exercise market power and to extend their current market power in the provision of local exchange services to long-distance services. In our Affidavit, we showed that it is much too early reliably to predict a speedy emergence of effective UNE-based entry, and that even if such competition does occur, its success is far from assured. This obvious point has been all but ignored in many of the reply comments. It is important, we believe, briefly to summarize the main reasons for our conclusion.

**A. UNE-based Competition Has Not Yet Been Tested in The Marketplace.**

7. UNE-based competition is a totally novel institutional arrangement for the provision of local exchange services. Its efficacy has not yet been tested in the marketplace. Although the ILECS are presently entering into agreements with potential CLECS for the provision of UNEs, these agreements are, to a large extent, merely on paper. In particular, neither the FCC, nor the State regulators, nor the parties involved

can be reasonably assured that the ILECS will be able to fulfill their obligations under these agreements in a timely and efficient manner. Thus, even setting aside the ILECS' anticompetitive motives for delaying and undermining UNE-based competition, there is an obvious and genuine concern that this novel entry arrangement may be very difficult to implement. For example, ILECS may find it technically difficult quickly to "cut over" large numbers of end-users to the CLECS. Or, they may encounter unforeseen technical difficulties in reconfiguring their network to accommodate the onset of competition.<sup>2</sup>

**B. There May be Natural Barriers to Entry Impeding Effective Competition**

from UNE-based CLECS, as well as from Any Facilities-Based Competitors.

8. As we discussed in our Affidavit, there may be significant natural barriers to entry into the provision of local exchange services. One plain source of such entry barriers is the need to expend sunk costs. While the sunk cost barrier is likely most significant for those entrants who wish to build out their own facilities, UNE-based entrants also face sunk cost entry barriers. For example, UNE-based entrants may find it necessary to incur significant sunk retail expenditures -- including costs of marketing -- that will not be recovered if entry proves to be unsuccessful. The entry deterring effects of sunk costs are magnified by likely extant scale and scope economies that make geographically broader and larger scale entry necessary for cost efficiency.

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<sup>2</sup> ILECS will predictably have incentives to emphasize and perhaps to exaggerate such technical difficulties.

9. As an additional example, it is possible that some UNE-based entrants would suffer reputational disadvantages vis-a-vis the entrenched incumbent LEC. The ILEC, in turn, will have potent incentives and ability to magnify its reputational advantages through marketing campaigns, and through anticompetitive discriminatory behavior designed to worsen CLECs' service relative to that of the incumbent. The effect of such conduct will be to increase CLECs' entry costs, slow down market penetration, and lessen the competitive constraint on the ILECs' provision of local exchange services.

C. ILECS have Active Incentives and Apparent Ability to Erect Artificial Barriers to Entry into UNE-based and Facilities-Based Competition.

10. As long as UNE- and facilities-based entry diverts business from the ILEC that otherwise would have yielded even temporary supra-competitive profits (i.e., quasi-rents), the ILEC will have anticompetitive incentives to manipulate its control over UNEs and other aspects of network access and interconnection. Such quasi-rents may be available from some local exchange services themselves, from complementary local services (e.g., "vertical services"), or from bundled long distance services.<sup>3</sup>

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<sup>3</sup> There are many examples of ILEC behavior that have the appearance of efforts to suppress competition. For example, the incumbent carriers continually resist the FCC mandate to combine unbundled network elements upon request, and critical operation support systems have yet to be implemented despite the Commission's January 1, 1997 deadline. The ILECs also continue to insist on embedded costs for collocation and some unbundled elements, as well as excessive nonrecurring charges that bear little relation to forward-looking costs. GTE has sought injunctions against state commissions and sued state commissioners personally in almost every state where it has arbitrated an interconnection agreement. Other carriers have challenged the validity of these agreements as well.

11. ILEC anticompetitive strategies are likely often to be difficult to detect. For example, they may appear to be colorably legitimate practices. They may entail manipulation of characteristics of monopoly bottlenecks that, because of the newness of the institutional arrangements and technological requirements, cannot be adequately monitored by regulators and competitors. The problems of detection are confounded by the substantial informational advantages possessed by the ILECs regarding the local exchange facilities and technology.

12. As we discuss below, these incentives and ability to disadvantage rivals are heightened by the market-based approach to access pricing outlined by the FCC, as compared to the TELRIC/TSLRIC approach that we advocated in our Affidavit. The "market" approach allows the ILEC to reap enormous rents from the provision of local exchange access when it retains a local customer. At the same time, contrary to various experts, UNE-based competition cannot be fully relied upon to wring out these enormous rents from access. Moreover, various commenters are also wrong when they assert that cross-subsidization, predation, and anticompetitive price squeezes are only rational when these strategies have a high likelihood of inducing rivals' exit from the market. We demonstrate that such strategies are perfectly rational when they act to preserve some portion of the presently available rents from the provision of access.

II. THE FCC PROPOSED APPROACH TO ACCESS PRICING MAGNIFIES ILEC INCENTIVES FOR ENGAGING IN PRACTICES THAT ANTICOMPETITIVELY DISADVANTAGE RIVALS.

13. Under the "market-based" approach to access pricing, flows of enormous rents to ILECs from access depend solely on the ILECs' ability to keep local customers from defecting to facilities- or UNE-based CLECs.<sup>4</sup> This is so because, when a CLEC "wins" a customer, it collects all the rents from both originating and terminating access associated with that customer. Hence, in addition to any other net returns from serving local and bundled-services consumers, there are billions of dollars of profits at stake from the provision of access. Consequently, these profits offer a most powerful set of incentives for ILECs to employ their control over monopoly bottleneck UNEs, and any control they have over access prices, in order anticompetitively to disadvantage their rivals for local service and for bundled interexchange and local service.

14. One way that ILECs may act on their anticompetitive incentives is to implement an anticompetitive price squeeze — i.e. an anticompetitive relationship between the ILEC's mark-up on access and the (lower) mark-up on the ILEC's own long-distance offering. In particular, this tactic confers an artificial advantage on the ILEC and a corresponding disadvantage on the IXCs in the sale of long distance services to end users and in the sale of complementary local exchange services by the ILEC. Inasmuch as these artificial competitive advantages and disadvantages

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<sup>4</sup> For brevity, we focus here on UNE-based competition. Nevertheless, much of the analysis offered here applies also to facilities-based competition.

strengthen the ILEC's ability to exploit scale and scope economies, they simultaneously weaken the ability of rivals to compete for UNE-based local and long distance services, and strengthen the ILEC's hold on rents available from access services.<sup>5</sup>

15. A related and complementary force arises under the "market-based" approach from the differences between the competitive pressures that may be experienced by an ILEC on its access prices and on its interexchange services (especially if the ILEC is permitted to sell interLATA services). Here, there would be direct competitive pressure on ILEC IX rates arising from (hoped-for) competition from CLECs that become UNE-based sellers of bundled local and IX services. Such a CLEC would pay no rents above the costs of the requisite UNEs for access, and so this competitive pressure would be relatively significant. In contrast, since access prices are not directly affected to the same extent by this interaction, there is, on net, less competitive pressure on them, even in this scenario with hoped-for competition from UNE-based CLECs. One consequence is that remaining customer market segments in which there is relatively little competition to the ILEC from facilities- and UNE-based rivals will be burdened by access prices that can remain an effective vehicle for extracting monopoly rents from the IXCs who serve those customer segments. Another consequence is that the ILECs will be motivated to maintain markups in their

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<sup>5</sup> An anticompetitive price squeeze may also enable an ILEC artificially to build its long-distance business and thereby evade and manipulate regulatory constraints. For example, an ILEC might benefit from shifting costs from the competitive and unregulated long-distance business to regulated services, including wholesale UNE transactions, where regulatory price constraints may soon or eventually be sensitive to accounting measures of allocated costs.

access prices above those in their IX rates, thus implementing an anticompetitive price squeeze against IXCs in rivalry for customers who do not wish to employ any available UNE or facilities-based local services of a CLEC.

16. While the proposed "market-based" approach to access pricing would magnify the anticompetitive incentives of the ILECs, a mandate to price access at TELRIC/TSLRIC would, in many respects, avoid such exacerbation. When access prices are set at TELRIC, the quasi-rents available from retaining the customer are reduced from their otherwise much inflated levels. As a result, the incentives to distort rivalry anticompetitively in order to retain the customer are diminished. Moreover, TELRIC-based access rates cannot be undercut by ILECs' own long distance rates without those services being priced below cost, with the ensuing red ink and visibility. Both of these effects obviously act as to deter this sort of an anticompetitive price squeeze.

III. The Commission Must Adopt Rational Standards For Assessing The Effectiveness Of Market Forces In Constraining ILEC Pricing Behavior.

17. The Commission has indicated that potential competition may justify increased regulatory flexibility. NPRM at ¶169.<sup>6</sup> In evaluating the impact of potential entry, the Commission must jointly consider the degree of likelihood entailed and the time that will pass before actual significant competition emerges. Schmalensee and Taylor have justified Phase I type triggers based on the likelihood of entry over a two-year horizon. Given the endemic uncertainties surrounding the introduction of UNE-based competitive opportunities, it is our view that it is too dangerous to base deregulatory measures on current judgments of what might be "likely" to occur competitively in two years.<sup>7</sup> After all, deregulation without genuinely effective competition will only engender additional distortions in pricing that benefits ILECs at the expense of competition and consumers.

18. Similarly, in evaluating the ability of potential or existing competition to constrain ILEC pricing behavior, the Commission should exercise great care. Contrary to the claims of a few commenters, analysis of market share and pricing trends should not be neglected in consideration of demand and supply responsiveness. So long as

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<sup>6</sup> We would encourage the Commission to delay consideration of the appropriate analysis for determining the effectiveness of competition in constraining ILEC behavior until a later proceeding. The Commission could make a more informed decision based on a more complete record and the additional insights that observing new developments in the telecommunications market over the next several months will provide.

<sup>7</sup> Even Schmalensee and Taylor (USTA) acknowledge that after two years competition may still be insufficient to constrain prices effectively.

an ILEC retains the lion's share of the market, it should bear the burden of proving that competition provides sufficient safeguards for competitors and consumers through clear and convincing evidence. By requiring clear proof of price constraining competition, the Commission can reduce -- though not eliminate -- a panoply of potential ILEC abuses.

19. Some carriers like Ameritech have gone so far as to suggest establishing presumptions that demand and supply responsiveness are high without any evidence to support their position. In particular, they claim that the use of competitive access providers demonstrates consumer willingness swiftly to respond to lower price alternatives. However, it is plain that such narrow evidence in no way demonstrates that there is sufficiently ubiquitous competition to drive down ILEC prices to competitive levels. For similar reasons, presuming high supply elasticity based on the existence of one or more interconnection agreements is unjustifiable in light of the numerous remaining entry barriers described in our first affidavit and above.

20. In short, there is no substitute for genuine analysis to ascertain whether or not there is effective competition to warrant deregulation of ILEC access pricing. We urge the Commission to employ its regulatory tools to implement competitive levels of access prices until it is clear that actual effective competition makes regulation unnecessary.

**DECLARATION**

**I, William J. Baumol, declare under penalty of perjury that the foregoing is true and correct. Executed on February 14, 1997.**

A handwritten signature in black ink, appearing to read "W. J. Baumol", is written over a horizontal line.

**DECLARATION**

**I, Janusz A. Ordover, declare under penalty of perjury that the foregoing is true and correct. Executed on February 14, 1997.**

Janusz A. Ordover

## DECLARATION

**I, Robert D. Willig, declare under penalty of perjury that the foregoing is true and correct. Executed on February 14, 1997.**

Robert D. Willig



Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

In the Matter of  
Access Charge Reform

CC Docket No. 96-262

**Reply Affidavit of Patricia D. Kravtin, Lee L. Selwyn and Joseph W. Laszlo**

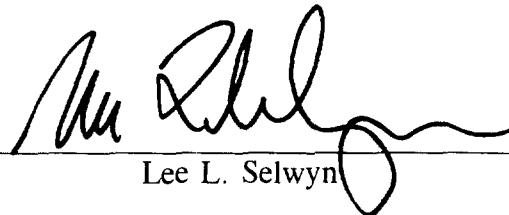
1. Our names are Patricia D. Kravtin, Lee L. Selwyn and Joseph W. Laszlo, Vice President—Senior Economist, President and Senior Analyst, respectively, of Economics and Technology, Inc, One Washington Mall, Boston, Massachusetts 02108. Economics and Technology, Inc. (ETI) is a research and consulting organization specializing in telecommunications economics, regulation and public policy. Our Statements of Qualifications appear as Attachments A, B and C to this reply affidavit. We submit this reply affidavit in response to the Commission's Notice of Proposed Rulemaking (NPRM) in CC Docket No. 96-262, Access Charge Reform, released December 24, 1996.

2. We prepared the attached report entitled "Reply to Incumbent LEC Claims to Special Revenue Recovery Mechanisms" on behalf of AT&T. The facts and analyses presented therein are true and correct to the best of our knowledge, information and belief.

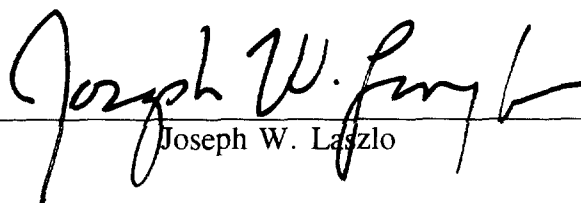
The foregoing statements are true and correct to the best of our knowledge, information and belief.



Patricia D. Kravtin



Lee L. Selwyn



Joseph W. Laszlo